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ROSE-COLORED GLASSES, OPAQUE FINANCIAL REPORTING, AND INVESTOR BLUES: ENRON AS CON AND THE VULNERABILITY OF CANADIAN CORPORATE LAW

JANIS SARRA[†]

INTRODUCTION

Enron's collapse, due to opaque financial reporting, self-dealing transactions, failed director oversight, and auditor conflicts of interest,¹ raises the issue of whether an Enron-type failure could happen in Canada. At the time of its collapse in December 2001, Enron Corporation was listed as the seventh largest company in the United States, with over \$100 billion in gross revenues and more than 20,000 employees worldwide.² Since then, shareholders have lost more than \$60 billion in market value,³ thousands of employees have lost their jobs, and creditors have lost billions in trade and other credit. This Article suggests that while there is an element of "Enron as con," Enron's collapse is also attributable to more systemic problems in both corporate law and securities regulation. Enron is extraordinary not only for its systems failure but also for the breadth and depth of harm inflicted on investors, workers, and creditors. Although some initially believed that Enron was an outlier in terms of its failed governance, it was quickly followed

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¹ At the time, Enron was the largest bankruptcy in U.S. history. WorldCom's recent bankruptcy filing involves almost double Enron's debt, with \$63 billion in debt and 65,000 employees. See Miro Cernetis, *WorldCom Largest Chapter 11 in History*, TORONTO GLOBE & MAIL, July 23, 2002, at A1.

² S. REP. NO. 107-70, at 6 (2002).

³ Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud and September 11, 2001*, 76 TUL. L. REV. 1579, 1592-93 (2002).

by the collapse of WorldCom, with 65,000 employees, and several other publicly traded companies. These failures collectively reveal serious systemic problems with the current corporate governance paradigm.

Canada may be equally vulnerable, given that its corporate regime mirrors much of the U.S. paradigm. Like their American counterparts, Canadians are increasingly vulnerable in that more individuals invest in the markets—frequently as a retirement plan. Almost fifty percent of Canadian adults own stock, which is double the number from two decades ago.⁴ The effect of Enron's collapse has rippled into Canadian markets, reducing investor confidence and raising public concern regarding the current regulatory system's ability to protect investors. In the past twenty-two months, there have been stock losses of \$450 billion in Canada—forty-three percent of the value of stocks.⁵ In July 2002 alone, investors withdrew \$1.1 billion from mutual funds.⁶

Corporate failure has a wide spread impact. It not only affects those shareholders with equity investments at risk; but it also results in job losses for employees, lost pension benefits, spin-off economic harm to communities, and enormous losses for consumers, small trade creditors, and senior creditors. While corporate insolvency and bankruptcy often are the result of market pressures or governance failures, few could have predicted the magnitude of Enron's failure of governance. The solutions currently being posed to protect Canadian investors are important and immediate. To date, however, the discussion of corporate law post-Enron has missed a valuable opportunity to more fundamentally consider corporate governance and stakeholder democracy.

This Article examines both the immediate implications of Enron for Canadian corporate governance and the more systemic issues that it raises. There are three highly interrelated aspects to Enron's collapse: (1) a failure of effective corporate governance and the implications for the shareholder primacy norm; (2) the limitations of securities regulation in the protection of shareholders and creditors; and (3) the role of auditors in

⁴ K. Foss & C. Alphonse, *Stocks*, TORONTO GLOBE & MAIL, July 20, 2002, at A5.

⁵ *Id.*

⁶ Dave Ebner, *Investors Flee Mutual Funds*, TORONTO GLOBE & MAIL, August 3, 2002, at B1.

effective investor protection. These issues arise against the backdrop of our market economy and increasing integration into global capital markets. In this context, it is important to remember that Anglo-American corporate governance is aimed at the efficient allocation and use of resources to generate surplus value and maximize return to shareholders. Thus, corporate law and securities laws, aimed at the protection of investors, are public laws that regulate the private ownership regime. Corporate governance is therefore situated in a highly codified property regime that reflects and reinforces the historical distribution of property.

As this Article will illustrate, the attention being given to protecting equity investors is very important to our market economy. Equity investors are essential participants because they provide capital at a reasonable cost—a key to generating productive activity and promoting societal wealth. It is important, however, not to lose sight of the fact that property losses from corporate misconduct at Enron have given rise to more regulatory, political, and media attention than other equally pressing issues of corporate misconduct—such as: serious environmental harms; occupational health harms; tort harms from consumer products; continuing racial and gender discrimination; and failure to comply with basic labor standards. These are also outcomes of failed governance standards; yet in the hierarchy of corporate misconduct, “property losses” to equity investors are given the highest priority and the most immediate attention. Issues such as gender and racial equality, protection of employment and labor standards, and corporate democracy require the same attention as investor protection.

Enron presents an important opportunity to more closely examine the current corporate governance model in terms of the diverse investments at risk in the corporation. While I have explored these issues generally elsewhere,⁷ they are discussed here specifically in a post-Enron context. Part I examines “Enron as con,” explaining how it was able to successfully mask its financial status to the detriment of shareholders, employees, and creditors.

⁷ See JANIS SARRA, CREDITOR RIGHTS AND THE PUBLIC INTEREST: RESTRUCTURING INSOLVENT CORPORATIONS (forthcoming 2002); Janis Sarra, *The Gender Implications of Corporate Governance Reform*, SEATTLE J. FOR SOC. JUST. (forthcoming November 2002).

Part II examines the Enron Board of Directors' view of transactions through "rose-colored glasses." This part also explores how lack of board diversity and failures in fiduciary obligation played a critical role in the company's failure. Canadian boards may be equally vulnerable to the incentives for shirking and self-dealing that the current regime creates. Further, Part II discusses the need to recast fiduciary obligation in a manner that accounts for the multiple interests implicated in corporate activity.

Part III examines the Canadian securities regulation regime. This part tracks regulatory change post-Enron, and the inherent limitations of some of these recent changes. Part IV discusses the potential for shareholder activism in Canada—an activism that is at its nascent stage. This part also poses suggestions for recasting the manner in which investors, including equity, debt, and human capital investors, view their role in governance of the corporation. Part V briefly examines the role of auditors and industry analysts as gatekeepers, focusing on the numerous conflicts of interest that have become entrenched in our securities regime.

Finally, the Article concludes that Canadian regulators, stock exchanges, corporations, and legislators have failed to engage in an adequate appraisal of corporate governance post-Enron. The enhanced disclosure requirements are solely aimed at increasing the wealth of equity investors, completely bypassing the debate regarding why property in this context is a higher value measure of effective governance than protection of other investments in the firm. Even within the shareholder primacy model, post-Enron securities and corporate law developments have only offered limited additional protection for shareholders, indicating the continuing potential harm even to equity capital investors. Until there is the political will to engage in more fundamental change, Canadian stakeholders will be vulnerable to Enron-type conduct.

I. ENRON AS CON

Enron was considered an industry innovator. It was a high-tech global corporation that traded energy contracts as marketable commodities.⁸ A U.S. Senate Committee Report

⁸ See S. REP. NO. 107-70, at 7 (2002).

concluded that Enron's strategy of utilizing these contracts as marketable commodities enabled it to develop and run its on-line energy trading business "outside of existing controls on investment companies and commodity brokers."⁹ Enron developed increasingly complicated transactions in order to enhance its credit rating and meet the heavy financing needs required to settle its energy contracts traded at the close of each business day. These transactions included:

[E]nergy contracts [that] Enron called "prepays" in which Enron was paid a large sum in advance to deliver . . . energy products over a period of years; designing hedges to reduce [risks inherent in] long-term energy delivery contracts; and pooling energy contracts and securitizing them through bonds or other financial instruments sold to investors.¹⁰

Enron's financing strategy also included making itself "asset light," by selling or syndicating its more traditional assets (such as capital intensive power plants) outright, or marketing interests in the assets to investors. The problem was the counterparties to these transactions. Rather than sell these property interests to third parties willing to invest in Enron's assets or share the substantial risks associated with long-term energy production facilities and delivery contracts, Enron sold these interests to "unconsolidated affiliates," which were not included in its financial statements, but rather were closely linked with the corporation.¹¹ Thus, the normal scrutiny that an independent third party would bring to the financial feasibility of this strategy was absent. Moreover, the off-balance sheet liabilities obscured both Enron's financial status and the level of risk involved in the energy contracts.

Enron also relied "on complicated transactions with convoluted financing and accounting structures, including transactions with multiple special purpose entities (SPEs), hedges, derivatives, swaps, forward contracts, prepaid contracts, and other forms of structured finance."¹² While some of these devices are currently utilized by corporations to assist in

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 7-8 (stating that by October 2000, Enron had a "total of \$60 billion in assets, of which about \$27 billion, or nearly 50 percent, were lodged with Enron's 'unconsolidated affiliates'").

¹² *Id.* at 8.

financing and risk diversification, they are typically made with independent third parties that are acquiring some portion of the business risk in exchange for the upside benefits of the corporation's economic activity.

Enron's accounting treatment of these transactions increased the immediate reported returns on its financial statements. These statements disguised Enron's actual level of running liability and did not indicate that Enron was essentially hedging its own risks—hence, the “con.” Enron's strategy of obscuring the true nature of the transactions also created conditions ripe for self-dealing transactions by managers.

Enron's Board of Directors (the “Board”), while aware of these transactions, viewed them through “rose-colored glasses.” The Senate Committee Report documents numerous occasions where warning signals were presented to the directors, and they consistently failed to question the transactions or the accounting practices. The partial list that follows gives the reader a sense of how heavily tinted those rose-colored lenses must have been.

In 1999, the Board was advised that Enron was using accounting practices that pushed the limits of acceptable practice, yet it failed to question why this was necessary or prudent.¹³ The Board also failed to question why Enron's gross revenues jumped from \$40 billion to \$100 billion from 1999 to 2000.¹⁴ The Board approved moving Whitewing, an affiliated company, off Enron's books, “while guaranteeing its debt with \$1.4 billion in Enron stock and helping it obtain funding for the purchase of Enron's assets.”¹⁵ Board members also signed off, without question or objection, on Enron's 10-K filings in 1999 and 2000 that recorded over 3,000 separate related entities, with over 800 organized in well-known offshore jurisdictions.¹⁶

On three separate occasions in 1999 and 2000, the Board approved unprecedented arrangements, which allowed Enron's CFO to set up private equity funds (the “LJM partnerships”) to do business with Enron for the purpose of improving Enron's financial statements.¹⁷ The Board waived the company's code of conduct, which prohibited Enron employees from obtaining

¹³ See *id.* at 12.

¹⁴ See *id.*

¹⁵ *Id.*

¹⁶ See *id.* at 23.

¹⁷ See *id.* at 24.

personal financial gain from a company doing business with Enron. Such a waiver was contrary to prohibitions on conflict of interest transactions; it allowed the CFO to establish and operate off-the-books entities designed solely to transact business with Enron.¹⁸

The Board's subsequent failure to monitor these transactions resulted in the LJM partnerships realizing hundreds of millions of dollars of profit at Enron's expense.¹⁹ Since the LJM partnerships essentially transacted business only with Enron, all these profits were at Enron's expense. For example, on several occasions, the LJM partnerships purchased Enron assets and then sold them back to Enron at a higher price.²⁰ The LJM partnerships reaped a termination fee of \$35 million when Enron unwound the Raptor transactions, discussed in the next paragraph, even though the hedging arrangement should have resulted in the LJM partnership paying Enron.²¹ The CFO was on both sides of the negotiating table in these transactions. In October 2001, the CFO advised the Enron Board that he had earned \$45 million on a \$5 million investment in the LJM partnerships in just two years.²²

In 2000, the Board approved several sets of complex transactions called the Raptors, despite questionable accounting and ongoing risk to the company.²³ It is likely that these transactions led to Enron's collapse. The purpose of the Raptors was to improve Enron's financial statements.²⁴ The Raptor transactions involved setting up SPEs using highly questionable financing transactions through the LJM partnerships to allegedly meet the requirement of independent equity. The LJM partnerships contributed \$30 million to each Raptor, giving the appearance of separate equity investment in the SPEs, only to have that investment paid back out to the LJM partnerships with a \$10 million profit on each Raptor SPE six months later—leaving claims on Enron's stock as the Raptors' only asset.²⁵ The Raptor SPEs thus appeared to hedge millions of dollars in

¹⁸ *See id.* at 24–25.

¹⁹ *Id.* at 24.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 37.

²³ *Id.* at 37–38.

²⁴ *Id.* at 47.

²⁵ *Id.* at 46.

volatile investments, when essentially Enron was inappropriately hedging its own risk, unknown to its investors and creditors.²⁶ The result was that losses of almost \$1 billion were "conceal[ed] from the market . . . by creating an appearance that [the] investments were hedged [by a third party; i.e., that the] third party was obligated to pay Enron the amount of those losses," when in reality the third party was an entity in which the major stakeholder was Enron.²⁷ When the value of the assets that were the object of the alleged hedges began to fall, there was "no economic substance—no assets or capital—[in the Raptors] to support the so-called hedges, other than claims on Enron's own stock or stock contracts."²⁸ Further questionable transactions and accounting sleights of hand created an unstoppable downward spiral in value.²⁹ Only at this point did Enron's outside auditor reverse its earlier opinion of the "proper accounting for the Raptors," deciding that the Raptor SPEs could not "continue to 'hedge' Enron's investment losses."³⁰ This resulted in a recorded "\$710 million charge to earnings; . . . investment losses that the Raptors no longer concealed."³¹ It also resulted in a \$1.2 billion reduction in shareholder equity because of the auditor's changed opinion as to appropriate generally accepted accounting principles (GAAP) in accounting for the Raptor transactions.³² In turn, investors reacted by selling shares, triggering a decline in stock price, a lowered

²⁶ Each of the Raptor SPEs was funded with only two types of assets; \$30 million provided by LJM, which was temporary and to be paid back as \$40 million within six months, and stock and stock contracts provided by Enron. In each case, LJM received its repayment and profit of \$10 million, leaving claims on Enron stock and stock contracts as the Raptors' only asset. Enron's liability for the Raptors was further increased in March 2001 by restructuring of transactions that committed further Enron shares, exacerbating the risk to Enron because Enron was effectively required to provide as many Enron shares as necessary to satisfy the Raptor "hedges." The Senate Committee Investigation found ample evidence of the Board's knowledge of these transactions. See *id.* at 46–48; see also the *Report of Investigation by the Special Investigative Comm. of the Board of Directors of Enron Corp.*, at 97 (February 1, 2002), available at www.enron.com/corp/pressroom/releases/2002/ene/docs/020202releaseltr.pdf [hereinafter *Powers Report*].

²⁷ *Powers Report*, *supra* note 26, at 4, 133; see also S. REP. NO. 107-70, at 44.

²⁸ S. REP. NO. 107-70, at 44.

²⁹ *Id.* at 44–45.

³⁰ *Id.* at 45.

³¹ *Id.*

³² *Id.*

credit rating, and eventually, bankruptcy.³³ The United States Securities and Exchange Commission (SEC) concluded in April 2002 that Enron's "financial statements were unreliable and the book value of its assets would have to be written-down as much as \$24 billion."³⁴

The above-cited examples of the failure of corporate directors to question or challenge these transactions are well documented by the Enron Special Investigative Committee Report (the "Powers Report") and the Senate Committee Report.³⁵ While the reader is well advised to read the reports to acquire a full appreciation of what transpired, these examples starkly reveal the failure of the corporate and securities law regime to safeguard investors. The abuses are almost inconceivable when tallied. On any measure of effective governance, the corporate directors failed.³⁶ The Senate Committee concluded that "[w]hile the evidence indicate[d] that, in some instances, Enron Board members were misinformed . . . overall the Board received substantial information about Enron's plans and activities and explicitly authorized or allowed many of the questionable Enron strategies," transactions and high-risk accounting practices.³⁷ The Board failed to exercise any effective oversight that would have ensured the integrity of corporate transactions and appropriate disclosures to the investing public. The Board sanctioned the opaque accounting practices and failed to monitor officers' conduct. The end result was "Enron as con," with devastating losses to tens of thousands of investors, creditors, employees, and pension beneficiaries.

II. DIRECTORS WITH ROSE-COLORED GLASSES

The classic law and economics view of corporate governance is that it is necessary for directors to exercise effective oversight in order to create a cost effective means to ensure that corporate officers make efficient decisions to generate wealth for the shareholders and to ensure that they do not engage in managerial opportunism or shirking. The notion of "Enron as

³³ *Id.*

³⁴ *Id.* at 11.

³⁵ See *supra* note 26.

³⁶ S. REP. NO. 107-70, at 13. The *Powers Report* came to the same conclusion. See *Powers Report*, *supra* note 26, at 22.

³⁷ S. REP. NO. 107-70, at 13.

con" and the officer self-dealing transactions are precisely what this approach is aimed at preventing. The Enron directors were in a position to prevent many of the failures in governance that occurred. The fact that this did not occur is in part a function of board culture and lack of diversity in representation on the Board. Enron directors were long serving directors, with financial ties to the corporation and unquestioning loyalty to the officers. This culture created complacency instead of a demand for accountability, and a failure to protect investors from inappropriate transactions and accounting irregularities. The Senate Committee Report concluded:

The Enron directors failed in their fiduciary obligations to safeguard Enron shareholders and "fail[ed] to recognize [their] fiduciary obligations to set the company's overall strategic direction, oversee management, and ensure responsible financial reporting,"³⁸ the Enron directors contributed to Enron's collapse by allowing the corporation to engage in "inappropriate conflict of interest transactions," extensive off-the books activities, and excessive executive compensation,³⁹

"[t]he Enron Board of Directors knowingly allowed Enron [to engage] in high risk accounting practices,"⁴⁰

"[d]espite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's [CFO] to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of the LJM transaction[s] and compensation controls and failed to protect Enron shareholders from unfair dealing,"⁴¹

"[t]he Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was, and [the directors] failed to ensure adequate public disclosure of material off-the-book liabilities that contributed to Enron's collapse,"⁴²

"[t]he Enron Board . . . approved excessive compensation for company executives, failed to monitor the cumulative cash

³⁸ *Id.* at 14.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* at 24.

⁴² *Id.* at 38.

drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by [the] Board Chair and [CEO] . . . of a company-financed, multi-million dollar, personal credit line";⁴³

there was a lack of independence of Enron directors; "independence . . . was compromised by financial ties between the company and certain Board members," including lucrative consulting fees in addition to their director compensation, and major financial donations to organizations in which board members were directly involved and from which they received income;⁴⁴ and

"[t]he [Enron] Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services [as well as] serving as Enron's outside auditor."⁴⁵

The Senate Committee made a series of recommendations to prevent such governance failures in the future. They include strengthening oversight by having directors of publicly traded companies take steps to:

- (a) prohibit accounting practices and transactions that put the company at high risk of non-compliance with GAAP and result in misleading and inaccurate financial statements;
- (b) prohibit conflict of interest arrangements that allow company transactions with a business owned or operated by senior company personnel;
- (c) prohibit off-the-books activity used to make the company's financial condition appear better than it is, and require full public disclosure of all assets, liabilities and activities that materially affect the company's financial condition;
- (d) prevent excessive executive compensation, including by—
 - (i) exercising ongoing oversight of compensation plans and payments;
 - (ii) barring the issuance of company-financed loans to directors and senior officers of the company; and
 - (iii) preventing stock-based compensation plans that encourage company personnel to use improper accounting or other measures to improperly increase the company

⁴³ *Id.* at 52.

⁴⁴ *Id.* at 54–56.

⁴⁵ *Id.* at 54.

stock price for personal gain; and

(e) prohibit the company's outside auditor from also providing internal auditing or consulting services to the company and from auditing its own work for the company.⁴⁶

The Senate Committee also recommended strengthening board independence by having the SEC and self-regulatory organizations, such as the national stock exchanges:

(a) strengthen requirements for Director independence at publicly traded companies, including by requiring a majority of the outside Directors to be free of material financial ties to the company other than through Director compensation;

(b) strengthen requirements for Audit Committees at publicly traded companies, including by requiring the Audit Committee Chair to possess financial management or accounting expertise, and by requiring a written Audit Committee charter that obligates the Committee to oversee the company's financial statements and accounting practices and to hire and fire the outside auditor; and

(c) strengthen requirements for auditor independence⁴⁷

The Senate Committee findings mirror those of the Powers Report, which found that, despite clear conflicts of interest for the CFO, the Enron Board inappropriately approved related-party transactions and subsequently failed to monitor these transactions in a meaningful way.⁴⁸ The Powers Report also found that the Board failed to question or consider the auditor's report that a significant hazard of the related party transactions was the "accounting risk" associated with the transactions.⁴⁹ Recent Canadian studies have advocated strengthening the audit committees of corporate boards. In *Beyond Compliance*, the Joint Committee on Corporate Governance made numerous recommendations regarding financial literacy of audit committee members, independence and accountability.⁵⁰

The failures of effective oversight commenced with the "rose-

⁴⁶ *Id.* at 4.

⁴⁷ *Id.*

⁴⁸ See *Powers Report*, *supra* note 26, at 148, 162-68 (discussing the conflicts and criticizing the attempted remedial measures).

⁴⁹ See *id.* at 25.

⁵⁰ See J. COMM. ON CORP. GOVERNANCE, *BEYOND COMPLIANCE: BUILDING A GOVERNANCE CULTURE*, at App. C (final report Nov. 2001) [hereinafter *BEYOND COMPLIANCE*] (listing the ten recommendations of the Blue Ribbon Committee on Audit Committee Effectiveness).

colored" glasses. Enron's corporate culture rewarded high-risk ventures, aggressive market behavior, and accounting that maximized reported earnings. Hesitation, questioning, or careful risk assessment were not part of the corporate program. The Board not only failed to exercise oversight, but as recently as during the Senate Committee hearings, Board members continued to state that they had done nothing wrong.⁵¹ The rosy view of corporate officers led to the approval of transactions that were clearly a conflict of interest for corporate executives and a breach of the directors' duty of care in allowing the transactions to proceed. The same rosy lens affected the corporate monitoring structures so that the Board failed completely in following through, and thus did not detect extensive self-dealing by corporate officers.⁵²

The first reaction of Canadian securities regulators and stock exchanges was that an Enron could not happen in Canada; it was our northern version of the rose-colored glasses. Market reaction in Canada suggested that investors were not as confident. Enron was not considered an isolated incident of failed oversight and investors did not have a rosy picture of the implications for Canadian corporate governance. In Canada, the hallmarks of good governance have been effective and independent oversight of the corporate board, transparency of corporate transactions, director accountability to shareholders, and auditors and similar professionals as gatekeepers or protectors of the integrity of the disclosure process. All of these elements are present in the United States regime as well. Yet, alone or in combination, they did not provide a check on corporate misconduct. Thus, at least to some degree, a similar governance failure could occur in Canada. Canada has had its share of securities scandals in the past, Bre-X to name one example, but nothing approaching the magnitude of Enron.⁵³ Effective oversight requires that corporate directors be able to think separately and independently from corporate officers. It is not sufficient merely to appoint corporate directors who do not meet the statutory definition of related directors. Rather, the board requires an ability to represent and present diverse views

⁵¹ See S. REP. NO. 107-70, at 13-14.

⁵² See *id.* at 13.

⁵³ See Jeffrey MacIntosh, *Lessons of Bre-X (?) Some Comments*, 32 CANADA BUS. L.J. 223 (1999).

on corporate activity, and to engage in healthy discussion and debate on the efficacy, goals, and risks of transactions that affect the financial and economic health of the corporation.

A. *Lack of Diversity of the Corporate Board*

The Enron Board was comprised of fifteen directors, several of whom had been on the Board of Enron or its predecessor companies for more than twenty years.⁵⁴ All but two were ostensibly independent directors, although, as noted above, many received lucrative consulting fees or donations to their place of employment or favorite charity. The Senate Committee Report discloses that in 2000 Enron directors received \$350,000 in cash and equity compensation—more than twice the national average for board compensation at U.S. publicly traded corporations.⁵⁵ Marleen O'Connor has also observed that all but one of the directors were male and that almost all were white business officers.⁵⁶ All these factors created a board culture that was unquestioning and far too homogeneous to provide for healthy scrutiny and monitoring of the corporate officers. Thus, "independent directors" is in itself insufficient guarantee of independent oversight. The Powers Report also found that the Audit Committee of the Board consisted of independent directors, but that they failed to investigate or give serious consideration to the related party transactions. The failure was exacerbated by the advice of Enron's auditor, with its multiple and conflicting interests.⁵⁷

Scholars Lynne Dallas and Marleen O'Connor have written about the dynamics of corporate boards and the problems associated with a lack of diversity of views and backgrounds, including the inability to question particular transactions, the need for conformity, the failure to bring diverse views to consideration of strategic decisions, fewer skills sets and experience to contribute to risk assessment, and a sense of morality that precludes questioning or challenge of group decisions.⁵⁸ Using Irving Janis' groupthink theory, O'Connor has

⁵⁴ See S. REP. NO. 107-70, at 8.

⁵⁵ *Id.* at 11.

⁵⁶ Marleen O'Connor, Address at the American and Canadian Law and Society Joint Conference (June 2002).

⁵⁷ *Powers Report*, *supra* note 26, at 17.

⁵⁸ Lynne Dallas, *Developments in U.S. Boards of Directors and the Multiple*

suggested that "groupthink" generated by shared backgrounds, financial incentives to bond together, and a board culture promoting unquestioning loyalty to Enron officers, prevented the Enron Board from critically evaluating decisions, and led to a sense of invulnerability in risk-taking decisions.⁵⁹

Problems associated with lack of diversity on corporate boards also exist in Canada. Women hold only 11.9% of corporate board seats, with very few non-white directors.⁶⁰ Canadian corporate boards tend to be almost entirely comprised of CEOs or former CEOs of other companies, because officer experience is generally thought to be an essential prerequisite for corporate directorship. Given that few women are CEO's, this creates a type of pre-selection. It also assumes that these are the only skills required by a corporate board. Boards have failed to recognize the contributions of women to corporate activity. Cohesiveness and compatibility are considered important qualities for a corporate director; however, compatibility is different from homogeneity. This lack of diversity creates the same risks of unquestioning conduct that occurred in Enron.

Canada faces additional challenges because many of its publicly traded corporations are closely held, and thus majority or controlling shareholders greatly influence who is nominated to corporate boards and how the "best interests of the corporation" get defined. While the closely held nature of publicly traded corporations may result in closer monitoring of officer performance, it can also increase the risk of collusion between controlling shareholders and corporate officers to the detriment of other investors.

A recent survey of corporations found that Canadian corporations may look increasingly to women for board seats because of the growing recognition of the need for financial literacy skills on boards and because women tend to occupy positions in the accounting and auditing fields. Women drawn from senior ranks of the accounting profession, however, are

Roles of Corporate Boards, in CORPORATE GOVERNANCE IN GLOBAL CAPITAL MARKETS (forthcoming 2003); O'Connor, *supra* note 56.

⁵⁹ O'Connor, *supra* note 56.

⁶⁰ See Canadian Women's Bus. Network, *Catalyst Census Posts Solid Gains in Percentage of Women Corporate Officers in America's Largest 500 Corporations* (Nov. 11, 1999), available at <http://www.cdnbizwomen.com/resources/catalyst11.html>.

likely to represent the same privileged class as current directors and thus, this shift will not necessarily create the diversity of views that would truly enhance corporate governance. Diversity requires representation not only by gender and race, but by different socio-economic classes in order to have the skills, information, perspective, and resources that will collectively enhance oversight. CEO experience is not essential for all directors; the board's role is to exercise oversight, not to manage the corporation. Financial literacy and other directing skills can be acquired, but the perspective of diverse stakeholders may be critical in how the board examines transactions that have the potential risk of creating consumer or investor harms, negative effects on products markets, environmental sustainability risk/benefits, and other transactions with broader social and economic costs. Given the economic status of women and their multiple caregiving responsibilities in our society, women frequently assess opportunity costs and transaction costs differently. This perspective is potentially valuable in enhancing corporate decision-making, particularly if that decision-making is recast to consider multiple equity, human capital and other investors in the firm.⁶¹ Importing a different mix of norms into the cost/benefit analysis engaged in by corporate officers has the potential to recast the calculus of corporate decisions, including consideration of costs to workers' lives, human rights, and the environment. Incorporating views from diverse racial backgrounds should generate a higher awareness of the need to not only comply with basic human rights laws, but to work towards eliminating discrimination in corporate operations, both domestically and internationally.

In post-Enron Canada, there is considerable debate regarding the current structure of board audit committees and whether they provide a sufficient check and objective assessment of the activities of corporate officers and their agents, and whether their mandate is sufficient to guard against self-dealing transactions. Canadian corporate boards are clearly vulnerable to the same kinds of influences that were faced by the corporate board in Enron. Absent diversity, board culture can create a dependence on corporate officers and an unquestioning culture

⁶¹ For a further discussion of this issue, see SARRA, *supra* note 7 (manuscript at ch. 3).

that prevents more objective assessment of particular transactions. While a cohesive board is essential to timely and effective decision-making, excessive cohesion prevents critical assessment of peer decision-making. In addition to assessing officer performance, there must be effective peer review of director performance. Integrity of financial standards is a key element of effective governance. The corporate board must have strong audit and strategic planning processes. The Enron fiasco has also highlighted the complex and nuanced relationship of the audit committee with external auditors.

With the move to global capital markets, corporate boards also need to offer a system of internal accountability for financial reporting and governance decisions in order to offer international investors some assurance of the upside potential of investing in the firm. There must be a deeper appreciation of cultural and social differences and different normative standards of good corporate conduct.

B. Fiduciary Obligation and "Investor Blues"

As noted above, the Senate Committee investigation found a failure by the Enron Board to meet its fiduciary obligations. Fiduciary obligations provide the normative standard against which the conduct and business judgments of directors and officers are measured. Fiduciary obligation is, therefore, central to an effective corporate governance strategy—a strategy that establishes a direction for the corporation, ensures oversight over corporate officers and their agents, and maximizes corporation wealth. The fiduciary obligation within the Anglo-American corporate law paradigm is almost exclusively to shareholders, although it can shift to creditors once a corporation becomes insolvent.

Enron was a failure in fiduciary obligation, not only to shareholders but also to others implicated in the corporation's activity. Given the normative pressure to report sustained short-term earnings in order to impress shareholders, the directors failed to meet their fiduciary obligation to engage in careful oversight. This produced disastrous results for equity investors, as well as others. In this respect, casting fiduciary obligation narrowly was detrimental to the long-term interests of equity investors. Faith Kahn has cogently analyzed how United States state corporate fiduciary law and federal securities law

support the principle of director responsibility, but courts and regulators have been reluctant to enforce this duty through personal liability, even where fraudulent conduct has been proven.⁶² Kahn suggests that the failure of regulators and courts to hold violators personally accountable contributed to a sense of invincibility among Enron's directors and officers.⁶³

Investor woes created by Enron's misconduct were particularly egregious because of the large number of small investors who sustained losses, including workers who had placed much of their surplus income in Enron as a retirement strategy. There is a distinction between equity investors who have tied-up their life savings in the markets in hopes of securing their share of the supposed "culture of generous equity return" and larger investors, whose actual capital investment is a greater dollar amount, but which represents a smaller portion of their total equity investments. Institutional investors are obligated through their fiduciary and trust obligations to diversify risk, thereby limiting the impact of any particular corporate failure. Moreover, many larger investors manage other people's capital and thus their personal equity capital is not at risk. Shareholders, therefore, have radically different risk capabilities, investment timelines, risk diversification capabilities, and information and resources to monitor corporate activity. Not only does this influence the short-term versus long-term investment and return timelines, it also has direct implications for the type of risks in which shareholders wish corporations to engage. While optimal investment practice assumes diversification of portfolios and ease of exit if equity investors are dissatisfied with corporate performance, these make huge assumptions about the sophistication of investors. It also requires a deeper appreciation of the power relationships, even within the existing shareholder wealth maximization paradigm. It is not enough merely to disclose corporate activity; a regulatory framework that recognizes these differences must be created.

Recognition of these distinctions in the nature of equity investment could also make investor preferences more visible. The current paradigm assumes that shareholders' sole concern is

⁶² See Kahn, *supra* note 3, at 1627-28.

⁶³ See *id.*

the maximization of shareholder return. Yet small investors are more likely to identify with the need to prevent corporate misconduct because they are themselves workers, consumers, parents, and community members. A recent survey of 2,006 Canadian adults, more than a third of whom were shareholders, found that seventy-four percent believe that corporate officers have a responsibility, in addition to profit making, to take into account the impact of their decisions on employees, local communities, and the country.⁶⁴ The governance debate has not been responsive to these indicators of public sentiment.

The most disappointing element of the governance debate post-Enron is that fiduciary obligation is not being more fully explored and re-conceptualized. Clearly, its current manifestation has limits even for shareholder protection. Yet there is a more fulsome analysis of the corporation that recognizes wealth maximization as the product of multiple inputs, equity capital investors, debt lenders, trade creditors, employee labor, loyalty and innovative contributions, and community infrastructure that supports the corporation's activities. These are all investments in the firm. Elsewhere I have suggested that the interests of creditors, workers, and other stakeholders run along a continuum of residual interest requiring that the shareholder wealth maximization paradigm be recast to recognize all the investments and interests in the corporation.⁶⁵ Yet the shareholder primacy norm continues to be deeply imbedded in Canadian and U.S. corporate law. While the language of corporate law specifies decision making in the "best interests of the corporation," that language has been consistently interpreted by the courts as referring to the best interests of the shareholders. Nonetheless, shareholders are not the only investors in the firm.

In part, this shareholder-centric focus arises because of the inherent conflict in securities regulation and corporate law. Securities law is aimed at protecting investors of issuing corporations, and thus by definition has shareholders as its

⁶⁴ See Canadian Democracy and Corp. Accountability Comm., *The New Balance Sheet: Corporate Profits and Responsibility in the 21st Century* (Jan. 2002), available at <http://www.corporate-accountability.ca/pdfs/FullReport2002.pdf> [hereinafter *The New Balance Sheet*].

⁶⁵ See Janis Sarra, *Corporate Governance in Global Capital Markets, Canadian and International Developments*, 76 TUL. L. REV. 1691 (2002).

primary concern. In responding to the recent market failures, securities regulators have increasingly focused on deficiencies in corporate governance that give rise to investor harms. There are parallels between these trends and legislative responses to employment standards and environmental protection, where regulators imposed responsibilities on corporate decision makers to deter misconduct that creates harms identified as contrary to public policy. The difference is that given the hierarchy of property in public and private law, securities reform has continually worked to reinforce the notion of shareholder primacy in corporate governance. Yet arguably, the "bundle of rights" enjoyed by shareholders are comparable in terms of public policy priorities to the bundle of rights enjoyed by others with interests or investments in the corporation. Shareholder primacy in corporate governance is therefore a contestable notion. Yet there continues to be inadequate conceptualization of the optimal model of corporate governance that reflects these dynamics.

Generally, law and economics scholars have suggested that shareholders, as residual claimants to the value of the firm's assets, have the greatest incentive to monitor managers and thus the shareholder primacy norm will prevent managerial opportunism or shirking. The logic of this rationale, however, is questionable in light of Enron. It is not merely the alleged fraud of Enron's senior officers, but rather a more deeply pervasive problem of Board passivity so long as Enron appeared to be providing incredible returns to shareholders. This creates *ex ante* incentives for corporate officers to neglect their fiduciary and statutory duties in favor of the mantra of shareholder return. It also creates enormous incentive to engage in self-dealing transactions, fraud, and less than transparent reporting on financial and other corporate activity.

The incentives are not a one-way street. William Bratton has observed that the short-term shareholder return pressures from increasingly concentrated institutional investors also created undue pressure to enhance balance sheet reporting.⁶⁶ Both Bratton and O'Connor have suggested that Enron's "rank and yank" system, where senior employees were ranked, and

⁶⁶ See William Bratton, *Enron: The Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1331 (2002).

those at the bottom of the curve fired, created a corporate culture where "winners took all" and officers' decisions were not questioned.⁶⁷ The Powers Report also discussed the system of employee loyalty, where questioning transactions meant dismissal.⁶⁸ The highly competitive nature of Enron's workplace is counter-intuitive to the way in which women generally work. Studies document that women generally bring skills of collaboration, problem solving, care giving, and risk assessment that considers broader interests to the workplace. Such skills were antithetical to the corporate culture at Enron and clearly not the skill set rewarded at the officer level.

The Enron Board's failure to ensure that adequate monitoring and accountability mechanisms were in place was a key breach of fiduciary obligation. Lessons can be drawn from other aspects of corporate law in this respect. In other contexts, Canadian corporate directors have been put on notice that their oversight obligations include monitoring and prevention programs. These arise where there is clear public policy and statutory regulation that assigns personal responsibility to directors for corporate misconduct or failures to act. In Canada, environmental law is perhaps the strongest example. The landmark decision on director liability in environmental protection is *R. v. Bata Industries Ltd.*,⁶⁹ in which the court held that due diligence is established where the directors and/or officers exercised all reasonable care by establishing a proper system to prevent the commission of environmental offences and by taking reasonable steps to ensure the effective operation of the monitoring system. As a result of the *Bata* judgment, Canadian courts are very clear on their application of directors' obligations in respect of environmental protection. The courts will examine whether: directors established a pollution prevention program; the program was inspected or supervised; each director ensured that corporate officers had been instructed to set up a system for ensuring compliance with environmental laws; officers of the corporation reported back periodically to the

⁶⁷ See *id.*; O'Connor, *supra* note 56.

⁶⁸ See Powers Report, *supra* note 26, at 97.

⁶⁹ [1992] 9 O.R.3d 329, 339, *modified*, [1993] 14 O.R.3d 354, *modified*, [1995] 25 O.R.3d 321 (finding that the degree of reasonable care to be exercised depends on the circumstances of the case and the precise language of the environmental protection legislation).

board on operation of the system; officers had been instructed to report any substantial non-compliance to the board of directors in a timely manner; a system of ongoing environmental auditing was in place; training programs were in place; and other indices of a pro-active environmental policy were present.⁷⁰ These preventive, monitoring, reporting, and training obligations could just as easily be applied to financial reporting, human rights compliance, labor standards, and stakeholder protection. While the tests are common law, they arise out of relatively strong environmental protection legislation that also imposes personal liability on corporate directors and officers for failure of the corporation to comply with statutory standards. Thus, to mitigate the risk of rose-colored director views of corporate activity, legislated standards need to focus the lens of director activity. Attaching personal responsibility to engage in effective risk assessment of various capital investments can sharpen and sustain that focus.

Corporate directors should ensure compliance not only with the law but also with the spirit of laws aimed at elimination of gender and racial discrimination and other corporate activity that has social and economic harm for society. Costs need to be measured to account for harms that are currently considered externalities. It is not sufficient to require securities disclosure of transactions "material" to the financial status of the corporation if the costs are externalized and thus never considered material.

A more fundamental rethinking of fiduciary obligation should include accountability to multiple stakeholders. Kellye Testy has suggested that one can work within the existing corporate law paradigm and also undertake a more fundamental re-conceptualization that will maximize social wealth. The suggested method utilizes shareholders and consumers to ensure that public laws and standards such as human rights and environmental protection are key parts of corporate objectives.⁷¹ Cheryl Wade has observed that the governance problems identified by the Enron failure should not overshadow the persistent lack of board oversight of human rights compliance,

⁷⁰ See *id.*; see also R. DAVIS & J. SARRA, *DIRECTOR AND OFFICER LIABILITY IN CORPORATE INSOLVENCY*, at ch. 8 (2001).

⁷¹ See Kellye Y. Testy, *Linking Progressive Corporate Law with Progressive Social Movements*, 76 TUL. L. REV. 1227, 1243–1247 (2002).

which has led to enormous costs to investors from loss of civil anti-discrimination suits.⁷² Professor Wade suggests that racially toxic corporate activity is economically costly in terms of harm to employees, loss of goodwill, cost of fighting civil suits, and losses to the corporate balance sheet and to investors.⁷³ She concludes that workplace discrimination continues to exist because boards fail to accept the inevitable wrongdoing of at least some managers and employees, thus, if the board is responsible for complying with the law, socially responsible corporate behavior may be enhanced.⁷⁴

The notion of fiduciary obligation and "equitable treatment" of shareholders and other stakeholders differs normatively across national borders and a cross-cultural theory must be developed to inform corporate governance norms, including the economic and social implications of gender, race, and class.⁷⁵ Much further cross-cultural collaborative research is needed to fully understand these influences, including how risks and benefits are assessed in terms of corporate activity in other corporate law paradigms. In the Anglo-American system, the voices of racial minorities are not represented in the corporate boardroom, and often not in the plant or office either, because they cannot get access to these jobs. Women of color are doubly disadvantaged by corporate policies and conduct that do not recognize their contributions to the corporation's productive activity. Diversity on corporate boards can enhance governance by generating new ideas and approaches to corporate decision-making, engaging in more rigorous monitoring, and eliminating pervasive forms of discrimination. Some costs not currently accounted for are social and economic harms caused by current corporate restructuring and global positioning; the full costs of corporate activity, including harms from harassment, health, and safety risks; and environmental and tort harms. Until these costs are allocated to corporations and their decision-makers in terms of statutory and/or judicially imposed liability, a shift in the normative paradigm is unlikely to occur.

⁷² See Cheryl Wade, *The Interplay between Securities Regulation and Corporate Governance: Shareholder Activism, the Shareholder Proposal Rule and Corporate Compliance with the Law*, in CORPORATE GOVERNANCE IN GLOBAL CAPITAL MARKETS (forthcoming 2003).

⁷³ See *id.*

⁷⁴ See *id.*

⁷⁵ See Sarra *supra*, note 65, at 1691.

In Canada, the debate about stakeholder interest and re-conception of the corporation is at a nascent stage. A January 2002 report by the Canadian Democracy and Corporate Accountability Commission (the "Commission") has advanced this debate by conducting national hearings and making a set of recommendations aimed at enhancing corporate governance.⁷⁶ A survey conducted for the Commission found that seventy-two percent of Canadians accept the right of corporations to make profits but also want corporations to accept a broader sense of accountability that extends beyond profit maximization.⁷⁷ Eighty percent of Canadians want corporate social responsibility standards established and a requirement that companies report their compliance with such standards so that shareholders and consumers can make informed decisions.⁷⁸ Thirty-six percent of those surveyed were equity capital investors, and the survey results revealed consistency in these views about corporate social responsibility across both shareholding and non-shareholding survey participants.⁷⁹ The survey⁸⁰ indicates that the public sentiment differs from the current dialogue among securities regulators, stock exchanges and corporate officers, which persist in governance reform in the context of the shareholder primacy normative model. The Commission's recommendations for reform of corporate governance include:

Urging corporations to develop governance structures that facilitate a "corporate culture supportive of corporate social responsibility," defined as the corporation responding to interests in addition to the interests of shareholders, including employees, suppliers, customers and communities;⁸¹

having corporations establish a corporate social responsibility board committee and appoint a senior executive as ombudsperson responsible for corporate social responsibility;⁸²

requiring corporations to disclose any corporate social responsibility policies and practices in their annual reports or

⁷⁶ See *The New Balance Sheet*, *supra* note 64, at 18–34.

⁷⁷ See *id.* at 41.

⁷⁸ See *id.* at 42.

⁷⁹ See *id.* at 41.

⁸⁰ See *id.* at 45–46. This poll, conducted with 2,006 adults through phone interviews from September 28, 2001 through October 8, 2001, is considered accurate within plus or minus 2.2%.

⁸¹ *Id.* at 31.

⁸² *Id.*

annually in information circulars as a condition of listing on Canadian stock exchanges, setting out their approach and assessing the extent to which their practices conform to corporate social responsibility guidelines set out in stock-market listing rules;⁸³

urging government to develop corporate social responsibility guidelines with reference to established international "indexes of corporate social responsibility;"⁸⁴

amending corporate laws to clarify the fiduciary obligations of directors, specifically so that "directors do not disregard entirely the interests of a company's shareholders in order to confer a benefit on a non-shareholder, directors [in discharging their duty to the corporation and in determining what they reasonably believe to be the best interests of the corporation] may consider" the effects of the corporation's actions on "employees, customers, supplier and creditors," the "communities in which the corporation operates," and the short and long-term "interests of the corporation and its shareholders;"⁸⁵

requiring large companies to provide "social audit" information on the implementation of corporate social responsibility policies and practices;⁸⁶

enacting a new law to protect employees against adverse employment consequences for "whistle blowing" on corporate non-compliance with laws;⁸⁷

having "Canadian governments . . . work diligently to ensure that existing corporate, securities, consumer, health and safety, criminal, environmental, food, water and other rules are properly enforced;"⁸⁸

having the Canadian government apply corporate social responsibility criteria in purchasing and export promotion decisions, requiring business to certify their adherence to core corporate social responsibility activities if they wish to take advantage of public resources;⁸⁹

allowing Canadian pension plan managers "to take corporate

⁸³ *Id.* at 18–19.

⁸⁴ *Id.* at 19.

⁸⁵ *Id.* at 24–25.

⁸⁶ *Id.* at 21.

⁸⁷ *Id.* at 22.

⁸⁸ *Id.* at 26.

⁸⁹ *Id.* at 27–28.

social responsibility matters into account,” and to “indicate in their statements of investment policies and procedures whether or not they take into account” corporate social responsibility guidelines;⁹⁰

letting the Canadian government promote multilateral inclusion of a “social clause” in trade agreements as well as a convention to outlaw violations of basic human rights, workers rights, and environmental standards as a prerequisite to membership in trade organizations. Failing success in three years, the government should unilaterally require Canadian companies to adhere to a core set of human rights standards in their overseas operations;⁹¹ and

enacting “laws barring corporate and union donations to political parties and candidates,” with greater public financing provided to ensure adequate financing of the Canadian political process.⁹²

The recommendations are aimed both at enhancing information to investors and the public, and requiring corporate structures to make individual choices about corporate social responsibility and disclose these choices. The recommendations on fiduciary obligation, while important, need to be accompanied by enforceable remedies by stakeholders with a direct interest in the corporation, or such change would only mirror United States constituency statutes, which in some instances have reduced, as opposed to increased, accountability to stakeholders. The Commission also makes an important link between the public and private law aspects of corporate activity and electoral democracy. The current shareholder wealth maximization paradigm is a function of longstanding property relations and those that are propertied are not going to divest their holdings in favor of a fundamental re-conceptualization of the corporation.⁹³ This, however, does not preclude multiple shorter-term strategies and new legislative standards that require corporations to fully disclose and account for their conduct. Statutory provisions enacting the Commission’s recommendations could also facilitate a potential alignment of the interests of shareholders, workers, and other stakeholders in

⁹⁰ *Id.* at 28.

⁹¹ *Id.* at 29–30.

⁹² *Id.* at 33–34.

⁹³ See Sarra, *supra* note 65, at 1708–1711.

having the corporation successfully generate wealth, sustain employment, and reduce human rights, environmental, and other harms.

III. SECURITIES REGULATION AND INVESTOR PROTECTION

Transparency and disclosure are the hallmarks of our securities regime. Financial statements have been viewed as an accurate source of information about a company's financial condition, allowing investors to make informed investment choices. Disclosure is viewed as the key element underpinning an effective capital market structure. Investors rely on accurate and informative financial statements in making decisions. Corporate directors are assumed to be exercising effective oversight in the reporting of such information. Post-Enron, the question is whether corporations, in complying with financial reporting requirements and in following GAAP in their disclosure practice, are really providing investors with information in a form that allows them to assess the risks and benefits of investing in the firm. Each day, there are media accounts of shaken public confidence in the market. Do GAAP allow corporations to mask or fail to disclose particular transactions, such that a more fundamental change in financial accounting and disclosure is required?

A. *Transparent Versus Opaque Accounting*

The focus of securities regulators post-Enron is on failure in accountability to equity investors and whether there is a need for enhanced regulatory protection or simply better enforcement of existing protection. The securities regime is aimed at regulating the activities of publicly traded corporations in the protection of investors. It sets the framework for how securities are offered and traded, disclosure standards, and protection against insider and other self-dealing transactions. These measures are all aimed at transparency and creating a "level playing field" for investors in their assessment of the risks and benefits of investing in a particular enterprise. Given that the securities regime is focused on the protection of property, it is focused on protecting equity investors. This is a vitally important regulatory function that assists in promoting economic growth and productive activity. It is important to note, however, that the distribution of property continues to be highly gendered,

given the historical distribution of property, and thus these protections are aimed at particular classes of people who have the economic resources to invest capital. While the number of individuals who invest is increasing, the proportion of capital investment attributable to small investors is declining, and institutional shareholders have become the main source of equity capital investment in Canada.

In terms of investor protection, unlike the United States, Canada has had a continuous disclosure regime. Corporations are required to disclose material changes that affect a corporation as they occur. The premise is that continuous disclosure is essential to promotion of active securities markets and enhanced investor protection. It is aimed at a continuous dissemination of information to the market, and thus, at least on paper, suggests that Canadian investors may be less vulnerable to an Enron type disclosure failure. A company that is a reporting issuer in Canada must comply with continuous disclosure requirements through electronic filings on the SEDAR system and public website.⁹⁴

Enron operated under the periodic disclosure regime of the United States and thus there were periods during which numerous transactions that did not need to be immediately reported to the market could occur. Moreover, while the United States regime requires accuracy in corporate disclosures, it does not require issuing companies to disclose all material changes. Post-Enron, statutory changes initiated by the SEC will move the U.S. system towards an enhanced disclosure regime, requiring corporations to disclose a specified list of transactions or events and to report their periodic earnings more quickly.⁹⁵

A key question underlying the efficacy of the current disclosure regime is the adequacy of corporate financial

⁹⁴ See ONTARIO SECURITIES COMMISSION, CONTINUOUS DISCLOSURE OBLIGATIONS, PROPOSED NATIONAL INSTRUMENT 51-102 (proposed June 21, 2002), available at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_51-102-20020621_notice_roc.htm (posted by the Canada Securities Administration to seek public comment on the disclosure requirements). Securities laws are aimed at the standards of information to be disseminated when issuing new securities, the ongoing requirements for information dissemination, and prohibitions on trading in securities of an issuer by insiders where there is an undisclosed material fact or material change.

⁹⁵ See Peter Ramjug, *SEC Rules to Quicken Firms' Filings*, TORONTO GLOBE & MAIL, Aug. 28, 2002, at B5.

statements. Accounting standards in the United States have resulted in narrowly written, detailed prescriptive rules, allowing corporations to “check the boxes” in disclosing their accounting practices. Enron’s SPEs were a classic example of this—liabilities were not consolidated on the financial statements. Absent an overall shared understanding of a standard of financial reporting and enhanced transparency on corporate performance, narrow rule compliance creates inappropriate ex ante incentives to obscure the financial implications of particular transactions. The line between “avoidance” and “evasion,” to borrow a phrase from tax law, is very fine. The Senate Committee Report called this “opaque” disclosure.⁹⁶ The dictionary defines “opaque” as non-transparent, obscure, cloudy, impenetrable, and murky;⁹⁷ these are all suitable descriptions of Enron’s financial reporting practices.

B. Material Transactions Reporting and the Narrowness of the Lens

A continuous disclosure regime is not without risks. A key feature of the Canadian disclosure regime is reporting “material” changes such that investors are fully informed of the business and affairs of the corporation.⁹⁸ In terms of disclosure requirements themselves, there is considerable latitude in defining what is a “material” event requiring disclosure.⁹⁹ Corporate officers, accountants, or other agents of the corporation may meet the letter of the continuous disclosure regime without meeting its spirit and intent, which is to provide investors with disclosure such that they can make informed choices. Short-term advantage from a liberal interpretation of “non-material” can cause a loss of investor and market confidence, with negative financial consequences for the corporation.

“Material” refers to events or transactions that may affect share or property value.¹⁰⁰ Thus, harms that are externalized need not be identified on the corporation balance sheet or be

⁹⁶ S. REP. NO. 107-70, at 12 (2002).

⁹⁷ WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 1579 (3d ed. 1993).

⁹⁸ *The New Balance Sheet*, *supra* note 64, at 16.

⁹⁹ *See id.* at 16–17.

¹⁰⁰ *See id.* at 16.

reported as "material" because they allegedly do not have a material impact on shareholder value. Such harms are considered to be part of the public law regime in terms of labor standards or environmental law, and thus not part of the securities law regime except where particular events have impacted on shareholder value. Given this definition of "material," transparency and disclosure are narrowly cast. Investors are not exposed to the social and economic costs of other harms being perpetrated by the corporation unless they are likely to influence the bottom line.¹⁰¹

A corporation should be obligated to disclose all costs associated with corporate activity so that investors, creditors, and other stakeholders can assess their continued investments. Such costs are quantifiable using GAAP and economic indicators. Even if including such costs on the corporate balance sheet is too radical a notion for current legislators, the requirement to disclose a separate balance sheet of the estimated social and economic consequences of particular decisions would integrate securities laws in the social and economic reality in which corporations participate. An effective continuous disclosure regime requires disclosure that is timely, relevant, understandable, and aimed at treating investors equitably. Securities law is "consumer protection for investors," and thus is highly integrated with other public law protections such as creditor enforcement systems; consumer protection; occupational health and safety law; employment standards; and environmental protection. To treat these laws separately, or cast some activity as private and the rest as public law issues, ignores the highly integrated public/private regulatory regime in which Anglo-American corporations operate. If Enron directors had been required to disclose the estimated social and economic costs of the risky SPE transactions to investors, the transactions would never have been approved. The directors would have known that investor confidence would plummet and capital would flee the corporation. Some might argue that such disclosure would create too much volatility in the markets. That volatility currently exists, however, precisely because investors are not confident of current corporate disclosures. Corporations should disclose any information that would help investors make

¹⁰¹ See *id.*

knowledgeable decisions in respect of their investments. Imposing a fiduciary obligation to report full estimated costs of particular corporate conduct would enhance the quality of decisions at the front end of the process.

It is equally important to recognize that not requiring disclosure of these harms as part of the securities regime creates ex ante incentives on the part of corporate officers to externalize the costs of some activities. The social and economic effects of labor shedding are a good illustration of this. While the financial statement records a savings in massive downsizing, the costs to the individuals from loss of deferred income, pension benefits, costs of relocating, social costs to family, and ripple economic effects on the community are not part of the disclosure as they are not "material" to the bottom line of corporate profit. As egregious as Enron-type failures in disclosures to investors are, the attention that has been given to correcting the financial disclosure regime is in part a function of property interests that were harmed. Yet securities regulation does not operate in a vacuum. It is situated in complex public and private law norms regarding harms and protections for multiple interested parties. The securities system should better recognize that equity investors may well have an interest in greater disclosure of the nature of corporate transactions that impact on these multiple concerns.

In the same vein, investor education has been aimed at discerning fraud, a focus reinforced post-Enron. Almost no attention is paid to education to promote diversification and reduction of risk, a key factor in the harms caused to Enron employees as shareholders. Disclosure is likely to be more effective where investor education includes instilling an ability to understand and make effective use of material disclosures. Moreover, little education or skills building is given to shareholders that facilitate their ability to make investment choices that reflect personal social and political beliefs. These issues are symptomatic of much larger systemic change that is required.

C. Regulatory Change Post-Enron

Post-Enron, a number of corporations have restated their financial positions. This is largely a function of economic incentives; an effort to restore market confidence; shareholders'

increasing vigilance; fear of director and officer tort liability and regulatory sanction; and an attempt to prevent further intervention by government in reporting requirements. These restatements have been buttressed by legislative initiatives such as the Sarbanes-Oxley Act of 2002, aimed at protecting investors by improving the accuracy and reliability of corporate disclosure pursuant to U.S. securities laws.¹⁰² This includes compliance with the new CEO and CFO certification requirements in respect of the "truth" of future annual and quarterly reports and disclosure of material facts; and certification that the financial statement and other information fairly present the financial condition the corporation.¹⁰³ The CEO and CFO must also certify that they are responsible for establishing and maintaining internal controls, that those controls will ensure that material information is conveyed to decision-makers, an evaluation and report on the effectiveness of these controls, and certification that they have disclosed to the corporation's auditor and audit committee any significant deficiencies in internal control and any fraud, material or not, that involved managers or other employees who have a significant role in the company's internal controls.¹⁰⁴ It also creates a public company accounting oversight board to protect interests of investors and the "public interest."¹⁰⁵

Canadian companies listed in the United States must comply with the Act.¹⁰⁶ Moreover, Canadian listed companies may feel some market pressure to comply with similar certification in order to retain investor confidence. It is too soon to gauge the effectiveness of the Act. Of particular interest to Canadian regulators are the new certification requirements, as Canada is likely to introduce similar officer certification requirements in 2003.¹⁰⁷ By placing direct responsibility on CEOs and CFOs, there will be higher demand on auditors to revise their accounting practices to move beyond GAAP. Investors, whether they are domestic or international, want

¹⁰² Pub. L. No. 107-204, 116 Stat. 745.

¹⁰³ *See id.* § 302 (to be codified at 15 U.S.C. § 7247).

¹⁰⁴ *See id.* § 302(a)(4).

¹⁰⁵ *See id.* § 101(a) (to be codified at 15 U.S.C. § 7211).

¹⁰⁶ *See id.*

¹⁰⁷ David Brown, President, CICA, Remarks to Senate Comm. on Banking, Trade and Commerce, at <http://www.osc.gov.on.ca/en/About/News/speeches.html> (October 30, 2002).

disclosure of information that identifies material risks or future expected changes that have some probability of affecting the value of their securities such that they can assess their investment options. It remains to be seen whether or not the Sarbanes-Oxley Act will really ensure transparency of corporate reporting and enhance investor confidence or merely serve as a new mechanism to insulate corporate officers. What is evident is that in both Canada and the United States, securities regulators have stepped up enforcement of securities law violations, which in turn may have significant deterrent effects in respect of corporate misconduct.

Canadian securities regulators have generally concluded that Canadian laws, if effectively enforced, adequately protect investors from selective disclosure.¹⁰⁸ In July 2002, Canadian securities regulators issued a new policy of best practices in disclosure, including that "companies must have written disclosure policies, [and] a senior officer or committee must police this policy;" and that there are specified "financial, operational and structural data that companies must release in a fair and careful manner."¹⁰⁹ "Material" information is now defined to include data on changes to accounting policies, changes in rating agency decisions, and any exceptions to corporate ethics or conduct practices that are put in place for key employees. They have also proposed new standards that would require disclosure of off-balance risks such as risks created by contractual obligations that would affect future cash flow of the enterprise. These are in addition to existing disclosure requirements. Blackout periods are to be used to prevent insiders from trading around key reporting periods. The policy suggests that the board or audit committee should review any disclosure regarding earnings guidance or any news releases containing new financial data. All information filed on the SEDAR website should also be immediately posted on the corporation's website; and any investor should be able to listen to analyst conference calls. This new policy of best practices also

¹⁰⁸ See Douglas M. Hyndman, *Canadian Securities Regulation: Challenges and Choices*, Address to the Canadian Investor Relations Institute (Sept. 12, 2002) (transcript available at http://www.bcs.bc.ca/bcproposals/bulletin_0919.asp).

¹⁰⁹ Richard Blackwell, *Securities Regulators Have New Disclosure Policy*, *TORONTO GLOBE & MAIL*, July 16, 2002, at B15; see also *The Accounting Standards Board of Canada*, November Decision Summary, at www.acsbcanda.org (November 11, 2002).

suggests that companies should be cautious in circulating analysts' reports to shareholders because this could be construed as endorsement of the report. "Companies are not prohibited from speaking to the media about non-material information or previously disclosed material information."¹¹⁰ These best practices will increase transparency; however, it is evident that their implementation will be resisted. For example, the TSX Venture Exchange has responded to this policy by expressing concern that more timely disclosure to shareholders may not be worth the added expense and has urged its listed companies to object to some parts of the policy.¹¹¹ Perhaps this indicates that even with all the post-Enron regulatory changes south of the border, enhanced protection of shareholder interests is resisted by some Canadian corporate interests.

In October 2002, the Ontario government introduced proposed changes to the Ontario Securities Act that will provide for civil liability in secondary market disclosure violations; create express prohibitions against securities fraud, market manipulation and misleading statements; grant new rule making authority in respect of audit committee standards and internal accountability controls; and strengthen the enforcement powers of the Ontario Securities Commission.¹¹² Moreover, discussions regarding whether there should be one national securities regulatory system instead of the existing thirteen have received new vigor in light of Enron.¹¹³

These initiatives are running parallel to "deregulation" initiatives, such as those proposed by the British Columbia Securities Commission. The Securities Commission's "deregulation project" is aimed at "streamlining the securities system," and replacing the current prospectus based system with a regime of periodic continuous disclosure of all material information.¹¹⁴ The British Columbia proposal would change the

¹¹⁰ *Id.*

¹¹¹ See TSX VENTURE EXCH., COMMENTS ON CSA CONTINUOUS DISCLOSURE PROPOSALS (Aug. 29, 2002), available at <http://www.tse.com/en/mediaNews/newsreleases/news3084.html>.

¹¹² Brown, *supra* note 107; Keeping the Promise for a Strong Economy Act, Ontario Legislative Assembly 198 available at http://www.osc.gov.on.ca/en/Regulation/ontario_securities.html (November 12, 2002).

¹¹³ FIVE YEAR REVIEW COMM. OF ONTARIO SECURITIES LAWS, DRAFT REPORT at www.osc.gov.on.ca/en/Summary/srac_5yr-mr-20020529.htm (May 29, 2002).

¹¹⁴ See BRITISH COLUMBIA SEC. COMM'N, NEW PROPOSALS FOR SECURITIES

definition of materiality to make it more expansive, requiring the reporting of all "material information" relating to the business and affairs of an issuer that would be reasonably expected to result in a significant change in the market price or the value of the securities. The "continuous disclosure" element of this project is critically important, and definitions of materiality and quality of disclosure are essential to investor confidence. Moreover, the detailed code of conduct will be replaced with a "principles-based code of conduct."¹¹⁵ The deregulation project also proposes new investor remedies in terms of actions against issuers, their directors and officers, and in some cases underwriters, for misrepresentations or failure to disclose material information on a timely basis. It includes increased enforcement powers for the commission. Again, this is potentially very positive or negative, depending on how the code is to be administered, what the financial statement requirements will be, the quality of disclosure standards to protect investors, and who in the system provides the accountability check through enforcement of standards. Measures are only as good as effective enforcement, and the British Columbia government's current downsizing and service shedding does not bode well for these changes in terms of whether the new standards will be rigorously enforced. Moreover, it is unclear whether small investors will be able to access these remedies.

U.S. stock exchanges have announced new listing standards to restore investor confidence, including, ensuring the independence of directors and strengthening corporate governance practice.¹¹⁶ The NYSE's new Corporate Accountability and Listing Standards also make important improvements in requiring audit committees to be comprised solely of independent directors; outside director in-camera meetings; enhanced internal audit functions; improved definitions of independence (no material relationship with the listed company); a code of business conduct and ethics; and CEO

REGULATION, available at <http://www.bcs.bc.ca/bcproposals/default.asp>.

¹¹⁵ *Id.* at 2.

¹¹⁶ See, e.g., Press Release, N.Y. Stock Exch., NYSE Approves Measures to Strengthen Corporate Accountability (Aug. 1, 2002), available at <http://www.nyse.com/press/NT00545421.html> [hereinafter NYSE]; Bureau of Nat'l Affairs, NASDAQ Approves Changes to Rules for Governance of Listed Companies (June. 3, 2002), available at <http://pubs.bna.com/ip/BNACgr.nsf/is/a0a5p7d3f4> [hereinafter NASDAQ].

annual certification that he or she is not aware of any violation of NYSE corporate governance standards.¹¹⁷ These standards will go a long measure towards investor protection, although their successful implementation requires some monitoring. NASDAQ will require tightening the definition of "independent director," require that related party transactions be approved by the audit committee or comparable body, and its new rules clarify that a company can be de-listed for misrepresenting information.¹¹⁸ In some cases, however, this is tinkering with rules on independence, as illustrated by the new NASDAQ standards set in respect of charitable donations.¹¹⁹ It is difficult to see how a director is independent if a \$200,000 donation can still be made to an organization of which the director is an executive officer.

In Canada, the Toronto Stock Exchange (TSX), which accounts for ninety percent of trading in Canada, continues to promulgate only voluntary guidelines, notwithstanding the fact that its own commissioned studies indicate that the majority of listed corporations do not meet the guidelines.¹²⁰ While the commitment to flexibility in governance structures is laudable, the failure to set some minimum governance standards is regrettable. The TSX has issued new proposed disclosure requirements and amended voluntary guidelines on corporate governance.¹²¹ The guidelines include enhanced disclosure on the number of unrelated directors on the corporate board. Furthermore, they suggest that audit committees should be composed only of unrelated directors; that the audit committee should draft a charter that sets out the audit committee's roles and responsibilities; and that all members of the audit committee should be financially literate, with at least one

¹¹⁷ See NYSE, *supra* note 116.

¹¹⁸ See NASDAQ, *supra* note 116. For example, current limits on director compensation of \$60,000 will extend to receipt of such payments by a family member of the director.

¹¹⁹ Contributions to charities where the director is an executive officer will be limited to the greater of \$200,000 or five percent of the charity's gross revenues if the director is still to be considered independent. *Id.*

¹²⁰ See TORONTO STOCK EXCHANGE COMPANY MANUAL ¶ 1400-306 (Oct. 7, 2002), available at <http://www.tse.com> [hereinafter TSX COMPANY MANUAL].

¹²¹ See TSX, REQUEST FOR COMMENTS, CORPORATE GOVERNANCE POLICY—PROPOSED NEW DISCLOSURE REQUIREMENTS AND AMENDED GUIDELINES (Apr. 26, 2002), available at http://tsx.com/en/tradingservices/docs/2450Apr26-02_Request_for_Comments.pdf.

member having accounting or related financial expertise. The guidelines stop short, however, of requiring the corporation to disclose the nature of the relationship of related directors with the corporation, critical to shareholder assessment of the ability of the directors to effectively oversee the activities of corporate officers. It fails to recommend that corporations disclose the results of shareholder votes. It does not create any guidelines for director remuneration, and it does not require compensation committees to be made exclusively of unrelated directors. The proposed guidelines also do not suggest that auditor's fees be reported broken down on the basis of services performed. Many of these governance changes are suggestions that have been highlighted in the public discourse post-Enron, and yet the Canadian version of rose-colored glasses is that these should not be mandatory features of the system.

The TSX has decided that it will not require listing companies to have an independent board chair, lead director, or board leader as a condition of filing, even though its own Joint Corporate Governance Project recommended this last year as an important feature of effective governance.¹²² The only actual requirement is that corporations report their governance practices, something that most have neglected to do so in the past.¹²³ The TSX reports that its mandate in respect of corporate governance is to require disclosure of corporate governance systems rather than legislate corporate governance standards.¹²⁴ Moreover, the corporate governance guidelines continue to be exclusively shareholder focused, as discussed above. The guidelines are silent on the need for, or benefits of, board diversity based on gender, race, or stakeholder interest.

D. Accounting Standards

While a full discussion of accounting standards is well beyond the scope of this Article, accounting is integrally linked to good governance. Canadian accounting standards differed from those in the United States for a number of years. Historically, the Accounting Standards Board ("AcSB") emphasized the identification of sound principles in setting accounting

¹²² See BEYOND COMPLIANCE, *supra* note 50.

¹²³ See TSX COMPANY MANUAL, *supra* note 120, ¶¶ 1400-772, -773.

¹²⁴ See *id.* ¶ 1400-773.

standards. This "principles-based" approach emphasized for many years the need for officers preparing financial statements to comply with the spirit and overall objective of financial reporting standards, exercising professional judgment based on those principles to reach sound conclusions as to the appropriate accounting for specific transactions. Yet as pressure for convergence of accounting standards within North America grew, Canada moved towards the rule-oriented approach of U.S. standards, with regulators issuing increasingly detailed interpretations of the application of particular standards. In turn, this has created the same sort of incentives to engage in financial reporting that utilizes loopholes in interpretation statements to avoid the reporting of particular events or transactions. Post-Enron, one issue is whether there will be some pressure to rethink this approach.

There is also reluctance to act in advance of the United States. For example, the AcSB is currently considering whether Canadian companies should be required to cost stock options in their financial statements, the concern being whether Canada would be competitively disadvantaged if this was mandated ahead of the United States.¹²⁵ Given corporate pressure, U.S. legislators backed down on requiring companies to report stock options as expenses, notwithstanding the fact that there are likely to be international standards that would require companies to treat stock options as expenses. While widely acknowledged that the market would benefit from such disclosure and that accounting standards would be of a better quality, accounting bodies have expressed concern about the "hit" that Canadian corporations would take in their income statements.¹²⁶ The issue is an illustration of how closely both our markets and our public policymaking are tied to the United States. Institutional investors in both Canada and the United States, such as the Ontario Teachers Pension Plan and TIAA-CREF have launched campaigns to pressure corporations to treat stock options as expenses in order to create transparency and accountability in how these options affect the bottom line of

¹²⁵ See CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS FORUM, STOCK-BASED COMPENSATION AND OTHER STOCK BASED PAYMENTS (Aug. 14, 2002), available at http://www.cica.ca/index.cfm/ci_id/1203/la_id/1.htm. [hereinafter CANADIAN INSTITUTE]

¹²⁶ *Id.*

the corporation's financial statement.¹²⁷

The objective of audited financial statements is to advise investors of the financial position of an issuing company, thus the statements should be aimed at fairly representing that position. There may also need to be enhanced accountability of corporate officers in ensuring that representation is accurate. As a direct outcome of Enron, the AcSB has issued new guidelines, aimed at enhancing transparency.¹²⁸ The guidelines on consolidation of SPEs and disclosure of guarantees are in the process of receiving public comment. The proposed Canadian guideline on "Consolidation of Special-Purpose Entities" is aimed at improving financial reporting of enterprises involved with SPEs, not to restrict the use of SPEs, on the premise that SPEs serve a valid business purpose of isolating assets or activities to protect the interests of investors or creditors, and/or to reallocate risks.¹²⁹ However, there needs to be transparency in the reporting relationship. The guideline would require that the assets, liabilities and result of the SPE's activities be consolidated in the corporation's balance sheet if it is a primary

¹²⁷ See ONTARIO TEACHERS' PENSION PLAN, A BETTER OPTION, *available at* <http://www.otpp.com/web/website.nsf/web/BetterOption>; see also Joann S. Lubin, *TIAA-CREF Wants Options Seen As Expenses*, WALL ST. J., July 24, 2002, at A3.

¹²⁸ The Accounting Standards Board (AcSB) is a professionally regulated body by the Canadian Institute of Chartered Accountants (CICA). See Chartered Accountants of Canada, <http://www.acsbcanada.org>. Since 2000, the AcSB and the U.S. Financial Accounting Standards Board (FASB) have been engaged in a program to harmonize Canadian accounting standards with those in the United States. For the FASB's interpretation of ARB No. 51, see FASB, CONSOLIDATION OF CERTAIN SPECIAL PURPOSE ENTITIES (Exposure Draft—Proposed Interpretation, June 28, 2002), *available at* <http://www.fasb.org> [hereinafter FASB PROPOSED INTERPRETATION]. The AcSB consists of "persons knowledgeable in the preparation and use of financial statements that are drawn from public practice, business and academe." ACCOUNTING STANDARDS BD., CASH FLOW AND OTHER PER SHARE INFORMATION (Proposed Accounting Recommendation, Apr. 2002), *available at* http://www.cica.ca/multimedia/download_library/standards/documents_for_comment/English/e_cashflow.pdf.

¹²⁹ See ACCOUNTING STANDARDS BD., CONSOLIDATION OF SPECIAL-PURPOSE ENTITIES, at i (Draft Guideline), *available at* <http://www.acsbcanada.org>. [hereinafter ACSB GUIDELINE]. As with the United States, the current practice in Canada is that SPEs are off-balance sheet and that even where there is a nominal owner, the activities of the SPE are not consolidated for income reporting purposes. See *id*; Press Release, Canadian Inst. of Chartered Accountants, Accounting Standards Board Issues New Guidelines to Improve Disclosure, Help Prevent Enron-Type Situation from Occurring in Canada (Aug. 9, 2002), *available at* http://www.cica.ca/index.cfm/la_id/1/ci_id/7794.htm [hereinafter Canadian Institute].

beneficiary that controls the SPE by means of variable interests.¹³⁰ The guideline will become effective for interim fiscal periods commencing on or after April 2003 for SPEs previously created, and for all SPEs created once the guideline is issued.¹³¹

While the guideline is aimed at harmonizing with the U.S. draft regulation, there are some specified differences. For example, the proposed Canadian guideline requires a judgment about whether an equity investment in an SPE is sufficient to finance the SPE's operations without relying on support from variable interest holders. In contrast, the U.S. standard creates an "investment of 10% of total assets" test, specifically that an equity investment of less than ten percent of the SPE's total assets is presumed to be insufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders.¹³² The Canadian AcSB concluded that this threshold is inconsistent with the underlying requirement that the amount of equity investment be greater than or equal to expected future losses and likely would result in a conclusion that the equity investment in an SPE is sufficient to finance the SPE's operations unassisted, in circumstances where this conclusion would be unwarranted.¹³³ It was concerned that it would set an arbitrary threshold that would then become a rule in practice.¹³⁴ Such specific differences are identified in the guideline, and are ostensibly aimed at greater transparency.¹³⁵

¹³⁰ See ACSB GUIDELINE, *supra* note 129, at i. Variable interests arise from certain contractual rights and obligations or ownership interests, and are the means by which an enterprise provides financial support for the SPE and by which it gains or loses from activities that affects the SPE's assets and liabilities. See *id.* Control is defined as holding a majority of the variable interests in an SPE or holding variable interests that are both significant in terms of the total variable interests and significantly larger than any other party's interest. See *id.*

¹³¹ See *id.* at ii. For annual and interim fiscal periods before the guideline becomes effective, an enterprise that is the primary beneficiary of an SPE or has a significant ownership interest should disclose general information regarding its relationship with the SPE, the nature and purpose of the SPE, and the expected effects on future periods' financial statement of consolidating SPEs, if known. See *id.*

¹³² See FASB PROPOSED INTERPRETATION, *supra* note 128, ¶ 9(b). The presumption is overcome if there is persuasive evidence that an equity investment of less than ten percent is comparable to the equity in businesses that engage in similar transactions with similar risks and that are not SPEs. See *id.*

¹³³ See ACSB GUIDELINE, *supra* note 129, at iii.

¹³⁴ See *id.* ("AcSB members could see no justification for establishing an arbitrary threshold that would become the rule in practice.").

¹³⁵ See *id.* (listing significant differences between the Canadian and U.S.

For example, where an enterprise with a variable interest in an SPE has not determined whether it is a primary beneficiary, the guidelines suggest that it should disclose that as well, including its relationship with and the nature and purpose of the SPE. Where it is the primary beneficiary, it should disclose the expected effects on future periods' financial statements of consolidating the SPE's assets, liabilities, and operating results, including the fair value of the SPE's assets, liabilities, and non-controlling interests at the end of its most recently completed fiscal period. Additionally, the SPE should disclose its revenues, expenses and net income for that period and any consolidating adjustments.¹³⁶ These guidelines respond directly to Enron's misuse of SPEs.

The AcSB has also issued a new "Disclosure of Guarantees" guideline that will "require [corporate] entities to disclose key information about types of guarantees that require payment contingent on specified future events, . . . [and require that disclosures regarding] guarantees be provided in interim statements where a change has occurred since the most recently completed fiscal year."¹³⁷ Both these new guidelines are a response to U.S. standards that the AcSB views as playing a key role in Enron's failure.¹³⁸ They are aimed at ensuring greater transparency and more accurate information for investors, analysts, and regulators about both risk and financial position of the corporation. They have also been harmonized with the U.S. standards.

These developments are important, although they also highlight a more systemic underlying issue—the malleability of accounting standards in general. The AcSB is also involved in discussions with the International Accounting Standards Board, which was recently established to promote harmonization of

proposals).

¹³⁶ See *id.* at 8. "Information is disclosed to the extent that it is available to the enterprise, [and] . . . when fair values . . . are unavailable, their carrying amounts are disclosed instead." *Id.*

¹³⁷ CANADIAN INSTITUTE, *supra* note 125; ACCOUNTING STANDARDS BD., DISCLOSURE OF GUARANTEES, (Draft Guideline), *available at* <http://www.acsbcanda.org> (effective for fiscal periods ending after December 31, 2002).

¹³⁸ See CANADIAN INSTITUTE, *supra* note 125 (quoting Paul Cherry, Chairman, Accounting Standards Board, concerning the research that "identified two standards that played a role in the demise of Enron").

accounting standards and provide reliable financial reporting to enhance investor confidence in global capital markets. It may also facilitate the exchange of lessons in respect of the rigor of accounting standards, and perhaps ultimately reduce those aspects of the malleability that work to the detriment of diverse investors who rely on the financial reporting in their investment decisions.

The International Organization of Securities Commissions, representing 16 securities regulators from developed markets, has formed a sub-committee comprised of senior representatives of member regulators to provide international co-ordination and response to the issues raised by the Enron collapse and other recent corporate failures. The sub-committee will examine how different jurisdictions address these issues, share the results of investigations, and make recommendations for reform. Once again, however, there appears to be a missed opportunity in rethinking securities protection. The operating paradigm is protection of equity investors. This is an important project, but should not be the only objective. For example, in addition to transparency requirements as a means of reducing managerial self-dealing, regulatory intervention could require reporting on human rights violations, environmental liability, and reporting on the social and economic cost/benefits of particular transactions. Increased requirements to discuss the risks of particular decisions to equity investors could be accompanied by disclosure of these social and economic risks. If investors are truly to make informed decisions in respect of their diversified portfolios, then they should be provided with these disclosures. As noted above, a recent Canadian survey found that seventy-two percent of those surveyed wanted corporate executives to take social responsibility into account in corporate decision-making, indicating a growing awareness of corporate decision-making on social and economic activity.¹³⁹ This awareness needs translation into a corporate law paradigm that takes account of the collective interests of broader stakeholders and long-term

¹³⁹ See VECTOR RESEARCH, ANALYSIS OF THE PUBLIC OPINION POLL CONDUCTED FOR THE CANADIAN DEMOCRACY AND CORPORATE ACCOUNTABILITY COMMISSION (2001), available at <http://www.corporate-accountability.ca/pdfs/PollReport.pdf> (noting that in a national sample of 2,006 individuals, seventy-two percent said "business should pursue social responsibilities, not just profits").

generation of economic activity, not merely short-term shareholder return.

Finally, this discussion exposes a more fundamental problem of our current capital markets. Corporations are dependent on the availability of cost-effective capital; in North America much of that capital is derived from securities markets and secondary trading. This dependence creates enormous power by large investors to influence corporate activity in their own interests. Absent externally imposed standards as to how capital is used and how costs are accounted for, corporations will necessarily conduct their activities with a careful eye on market reaction. While facilitating the expression of investor preferences should strengthen corporate accountability, investors represent only a fraction of society, the fraction that has surplus property to invest. Capital markets cannot and should not replace public law standards and enforcement. What is required is a conception of the corporation that integrates public policy across a range of issues, instead of isolating the securities regime as a "private law."

IV. SHAREHOLDER ACTIVISM

In Canada, shareholder rights and remedies are codified in both corporate law and securities laws, and are governed by a mixed federal and provincial legislative scheme, creating some inconsistencies across systems.

Shareholder activism in Canada has been confined largely to "exit" as opposed to "voice," in part, the result of corporate laws that until recently limited the scope of shareholder activism. Amendments to the Canada Business Corporations Act (CBCA) in 2001 included a number of provisions relating to corporate governance and enhancing shareholder involvement in corporate decision-making.¹⁴⁰ The principal changes are directed at shareholder participation, including enhanced access to disclosures; removal of former prohibitions on shareholder

¹⁴⁰ See Canada Business Corporations Act, R.S.C., ch. C-44 (1985) (Can.); Canada Business Corporations Regulations, 2001 S.O.R. 01-2139; see also Industry Canada, *Regulatory Impact Analysis Statement*, available at <http://strategis.ic.gc.ca/SSG/cs01381e.html> (indicating that the Canada Business Corporations Act was significantly amended to improve the legal framework for federal corporations by enhancing shareholder input and providing corporations with greater flexibility).

communications; use of new technologies in communication; the ability of corporations to hold electronic meetings; and revised proxy rules aimed at facilitating shareholder communication and participation. There are also new shareholder remedies such as liberalized proposal rules; ability to commence a civil action for insider trading; new protection for minority shareholders on a squeeze-out; and provisions governing unanimous shareholder agreements.

Shareholder proposal provisions are generally aimed at enhancing accountability of corporate officers and allowing shareholders an increased opportunity to participate in governance decisions. The new shareholder provisions in the CBCA have elements that may both enhance and detract from this objective. There are new holdings requirements before a shareholder can bring forward a proposal. A shareholder must alone or in combination hold one percent of the total number of outstanding voting shares or \$2,000 in market value of shares for at least six months, before the shareholder is entitled to submit a shareholder proposal.¹⁴¹ While shareholders can combine their shares to accomplish this, it is unclear why the threshold was necessary when there was no evidence of any abuses when there was no threshold. It appears to unnecessarily exclude small investors. The wording limit of a shareholder proposal was increased to 500 words that management must include in its proxy circular, affording shareholders slightly better opportunity to explain the rationale underlying their proposal.¹⁴² A proposal may include nominations for the election of directors if the proposal is signed by shareholders with five percent of holdings, but this does not preclude nominations being made at a shareholder meeting.¹⁴³

The reforms are likely to increase the scope and content of shareholder proposals. Until late 2001, under the CBCA, corporate officers could refuse to circulate a shareholder proposal on the ground that "it clearly appears that the proposal is submitted . . . primarily for the purpose of promoting general

¹⁴¹ See Canada Business Corporations Act, R.S.C., ch. C-44, § 137(1.1) (2001) (Can.).

¹⁴² See *id.* § 48. However, new word limits on the proposal itself means there is some question as to whether this is a gain.

¹⁴³ See *id.* §§ 46, 52, 53.

economic, political, racial, religious, social or similar causes.”¹⁴⁴ This provision had the effect of halting efforts by shareholders to use the proposal process to inject corporate accountability and corporate responsibility into decision-making. Cases such as *Re Varsity Corp. and Jesuit Fathers of Upper Canada*¹⁴⁵ upheld directors’ exclusion of proposals on the basis that they were primarily for political purposes, in that case aimed at eliminating apartheid. The new language allows corporate officers to refuse to circulate a proposal where it “clearly appears that the proposal does not relate in a significant way to the business or affairs of the corporation.”¹⁴⁶ This language is on its face more expansive and could eliminate a key barrier to shareholder proposals. It is based on the language of U.S. statutes, however, and in the United States there has been an uneven history in the SEC’s and the court’s deference to exclusion of proposals because they “arise out of the ordinary course of business.”¹⁴⁷

Lynne Dallas has observed that shareholder voting can allow a wider expression of preferences, a means of enhancing social responsibility, and ultimately greater accountability of managers.¹⁴⁸ The recent changes to the CBCA also increase the ability of shareholders to communicate with one another, although the statute imposes an arbitrary limit of fifteen shareholders allowed to communicate before dissident proxy circular requirements are activated.¹⁴⁹ Shareholders can now publicly communicate their intention to vote a particular way in public speeches, press releases, websites, and other broadcast media, without activating the solicitation prohibitions.¹⁵⁰ Given the recent enactment of these measures, it is too early to gage the potential for shareholder activism. Unlike the United States, Canada has not had a strong history of shareholder activism. This is likely to change. Recently, the Shareholder Association for Research and Education worked with

¹⁴⁴ See *id.* § 137(5) prior to the most recent amendments.

¹⁴⁵ [1987] 60 O.R.2d 640 (stating that the “issue of apartheid in South Africa [has a] nefarious effect on investment”).

¹⁴⁶ See Canada Business Corporations Act, R.S.C., ch. C-44, § 137(5)(b.1) (1985) (Can.).

¹⁴⁷ See Wade, *supra* note 72.

¹⁴⁸ See Dallas, *supra* note 58.

¹⁴⁹ See Canada Business Corporations Act, R.S.C., ch. C-44, § 150 (1985) (Can.).

¹⁵⁰ See *id.* §§ 68, 147.

institutional shareholders such as the Régime complémentaire de retraite du syndicat des pompiers de Québec on a shareholder proposal asking Hudson's Bay to improve its code of conduct in respect of sweatshop abuses in its supply chain.¹⁵¹ The proposal asked the company to purchase contracts to meet the ILO's Declaration of Fundamental Principles and Rights at Work and to establish an independent monitoring process to evaluate compliance. The proposal cast the issue as requiring stronger policies and greater transparency about compliance, which would in turn reduce risks to shareholders. These risks include threat of lawsuits from affected workers, damage to the company's reputation, and potential for consumer backlash. The proposal garnered thirty-six percent of shareholder support, and while it did not receive a majority, it sent a strong signal to corporate officers, as well as drawing considerable public attention to the corporation's current practices.

The Ontario Teachers' Pension Plan (OTPP), representing over 300,000 current, former, and retired teachers, has enhanced the transparency of its voting record by posting its proxy voting record and its rationale for positions taken on specific proposals on its website. OTPP has focused on relationship investing, aimed at maximization of long-term shareholder value through best governance practices, dialogue with corporate officials, voting all proxy votes that it is eligible to vote, and where necessary, sponsoring resolutions. OTPP is also lobbying for regulatory change to require corporations to comply with corporate governance standards. It advocates requiring corporations to "publicly disclose the details of all votes taken at annual or special meetings of shareholders."¹⁵² OTPP also promotes pension law change to emphasize the duty of investment managers to vote their proxies and to disclose to beneficiaries how they voted; currently only sixty percent of

¹⁵¹ See S'HOLDER ASS'N FOR RESEARCH AND EDUC., RECORD NUMBERS SUPPORT SHAREHOLDER RESOLUTION AT THE BAY ON SWEATSHOPS (May 23, 2002), *available at* http://www.share.ca/research/social_resp_investor_main.htm (describing overwhelming support for a resolution calling for an end to alleged sweatshop abuses).

¹⁵² Letter from Brian J. Gibson, Ontario Teachers' Pension Plan Board, to Hon. Leo Kolber, Chairman, The Standing Senate Comm. on Banking, Trade and Commerce (May 26, 2002) (*available at* <http://www.otpp.com/web/website.nsf/web/home>).

these shares are regularly voted.¹⁵³

Recently, institutional shareholders representing \$500 billion in assets (\$350 billion invested in Canadian publicly traded corporations) formed the Canadian Coalition for Good Governance.¹⁵⁴ The group includes pension funds, mutual funds, and money managers, and its express goal is to align the interests of managers with those of shareholders. Such a coalition is likely to enhance corporate governance practice, particularly if the coalition utilizes its proxy voting power to influence change.

However, the alignment of shareholder and managerial interest does not always mean that the interests of other stakeholders will be protected. It is premature to speculate on these issues. A key question will be how these investors approach the interests of stakeholders and the question of balancing those interests with their own beneficiaries. In many cases, these interests align. The timeline that these shareholders focus on is also important, because short-term return, as opposed to long-term investment tends to push corporate managers into making decisions that harm workers and create short-term earnings in order to keep investors satisfied. In this respect, there may be a qualitative difference between pension funds, which are trustees for pensioners and workers, and other institutional investors whose objective is short-term return. Scholars such as Susan Stabile and Ron Davis have suggested that pension funds may offer a means of greater corporate democracy because of the economic power they wield, depending on how they view their fiduciary and trust obligations.¹⁵⁵

V. AUDITORS AS GATEKEEPERS

There is a pressing issue of the role of external auditor that has yet to be resolved in the Canadian system. Enron's external

¹⁵³ See *id.*

¹⁵⁴ See ONT. TEACHERS' PENSION PLAN, INSTITUTIONAL INVESTORS FORM COALITION TO FIGHT FOR IMPROVED CORPORATE GOVERNANCE (June 27, 2002), available at <http://www.otpp.com/web/website.nsf/web/coalitionforcorpgov>.

¹⁵⁵ See *Enron Hearing Before the Senate Comm. on Governmental Affairs*, 107th Cong. (2002) (statement of Susan J. Stabile, Professor, Saint John's University School of Law), available at http://www.senate.gov/~gov_affairs/020502stabile.htm; Ronald B. Davis, *Enron and Two Aspects of the Pension Puzzle* (Sept. 2002) (on file with author).

auditor earned \$27 million in consulting fees and \$25 million in audit fees from Enron in 2000, and the Senate Committee Report concluded that this amount of earnings seriously compromised the independence of the auditor.¹⁵⁶ Current practices create incentives for auditors to compromise the reliability of financial statements in order to retain lucrative consulting contracts and to preserve close working relationships with corporate managers. Enron and other recent failures of public traded companies have necessitated corporate boards examining their relationship to the corporate auditing firm. There is a serious question of whether external auditors can make an objective assessment of the company's financial statements when the auditor's accounting firm is dependent on the lucrative fees from provision of other services to the corporation.¹⁵⁷ Yet lucrative consulting fees are a major source of revenue for accounting firms, and it is unclear that they will move internationally to divest these activities. A key part of Anglo-American corporate board structure is the audit committee and its relationship to the external auditor. The auditor is responsible for providing an independent assessment of the firm's financial and economic status. Absent an effective and independent external audit process, directors, investors, and creditors are unable to make informed choices. If the external auditing firm is too close to the corporation's officers, there is both financial and normative pressure to report the financial affairs of the corporation in such a way as to present the most positive picture to the investing public.

Canadian firms suffer from the same conflicts in terms of provision of consulting services and the concurrent provision of audit services. Aside from whether objectivity in auditing is possible in such instances, it is evident post-Enron that there is a serious loss of investor confidence in financial disclosures when these relationships exist. The issue of public confidence is also important to any shift in accounting standards away from prescriptive rules and greater dependence on broader principles

¹⁵⁶ See S. REP. NO. 107-70, at 58 (2002).

¹⁵⁷ See *The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?: Hearing Before the Senate Comm. on Commerce, Sci. and Transp.*, 107th Cong. (2001) (testimony of John C. Coffee, Jr., Professor, Columbia University Law School) (offering an insightful analysis of the role of Enron's external auditor).

and the professional judgment of auditors. New standards issued by the Assurance Standards Board of the Canadian Institute of Chartered Accountants require that the auditor address with the Audit Committee both the quality and the acceptability of the accounting policies adopted by a company. The auditor should also disclose potential conflict of interest or other involvement in corporate activity that may impact on the ability to give an objective assessment of the financial status of the corporation, including reporting on all non-audit services provided to the company and related fees. Directors have an obligation to satisfy themselves that non-audit services do not impair the auditor's objectivity or integrity of the financial reporting.

While it makes some sense for a professional body to regulate itself, governance of those professional bodies also requires some independent oversight. In July 2002, the Canadian Institute of Chartered Accountants announced a new independent public oversight for auditors of public companies ("the Accountability Board").¹⁵⁸ The new Accountability Board is aimed at restoring investor confidence and protecting the public interest.¹⁵⁹ Unlike the Public Accountability Board that has been legislated in the United States to reform oversight and improve accountability of auditors of public companies,¹⁶⁰ this is a move by the industry to pre-empt legislation. It is not yet clear what its mandate will be and how it will fulfill its accountability obligations.

There are also proposed new standards on independence of auditors, draft guidelines on management discussion and analysis of reports, greater inspection of auditors, and a new Auditing and Assurance Standards Council. Further study of these initiatives will be necessary to determine whether or not they adequately respond to the problems identified in the current auditing regime.

¹⁵⁸ See Press Release, David Smith, Statement on New Independent Public Oversight for Auditors of Public Companies (July 17, 2002) (*available at* http://www.cica.ca/cica/cicawebsite.nsf/public/Sp_Smith4) (noting that the chartered accountant profession has a role to play in reforming the financial system in numerous areas).

¹⁵⁹ See *id.*

¹⁶⁰ See Press Release, U.S. Securities and Exchange Commission, Commission Formally Proposes a Framework of a Public Accountability Board (June 20, 2002), *available at* <http://sec.gov/news/press/2002-91.htm>.

There is also likely to be a shift in the manner in which securities analysts will be regulated in Canada. In August 2002, CIBC World Markets Inc. became the first Canadian-based brokerage firm to revamp its stock rating system since U.S. dealers were implicated in the Enron and other corporate crises.¹⁶¹ A Securities Industry Committee on Analyst Standards, chaired by Purdy Crawford, reported in 2001 and made thirty-three recommendations to deal with conflicts of interest and failure to disclose ties between securities analysts and the firms on which they were reporting.¹⁶² The recommendations call for mandatory disclosure of conflicts of interest for the broker and analysts, prohibition of certain relationships for analysts producing research, recommending best practices for the issuance of securities analysts reports, and a number of recommendations that focus on good governance. If implemented, these would go some measure to reduce many of the serious problems that currently exist with analysts as one of the "gatekeepers" of the integrity of the securities regime.

CONCLUSION

The most disappointing aspect of the debates arising out of Enron is that it has not been viewed as an occasion for more fundamental thinking about the role of corporate governance and participation in capital markets. Economic activity that results in the generation of goods and services is essential to economic growth and enhancing social welfare. The financial markets do allow access to affordable capital, however, according to one economist, only three cents of every dollar traded on the TSX since 2000 have gone towards actually raising new money for investments.¹⁶³ The gap between the capital required for productive activity and the speculative nature of capital markets is increasing. This poses new challenges for how we conceptualize the corporation and its ability to attract capital for future productive activity.

¹⁶¹ See Richard Blackwell, *Move Follows Action at U.S. Firms*, TORONTO GLOBE & MAIL, Aug. 26, 2002, at B1.

¹⁶² See SECURITIES INDUSTRY COMMITTEE ON ANALYST STANDARDS (SICAS), FINAL REPORT (Nov. 14, 2001) (on file with author).

¹⁶³ See Jim Stanford, *The End of the Market?*, TORONTO GLOBE & MAIL, June 27, 2002, at B1.

Enron and the subsequent revelations at other large U.S. publicly traded corporations have challenged the widely accepted belief that our system of regulation, disclosure, and market adjustment adequately protects investors, employees and pensioners. The current governance structure of Canadian corporations is vulnerable to some of the same confluence of factors that resulted in a failure of governance at Enron. In Canada, there may be additional factors as a result of our publicly traded corporations being largely closely held, including: increased risk of managerial and majority shareholder collusion and opportunism to the detriment of the interests of smaller investors; social norms that militate against increasing board diversity; a failure to require a high level of financial literacy of corporate directors; and failure to cost all the effects of particular corporate conduct. The current Canadian securities regime, modeled after the U.S. regime, is an enabling regime that is aimed at allowing corporations to raise capital in a cost-effective manner while ensuring a high level of disclosure so that investors can make informed choices about risk/return on their investments. Yet it is still unclear that corporate boards and their auditors as gatekeepers ensure that corporate transactions are sufficiently transparent such that investors can make informed choices.

Only costs internal to the corporation are measured in determinants of corporate success, primarily through the measure of return to shareholders. It completely bypasses the debate regarding why property in this context is a higher valued commodity than human capital or other investments. It misses an important opportunity to more fully consider the integration of corporate, securities, and other public law regimes in terms of the normative underpinnings and public policy goals of corporate activity. It bypasses any discussion as to whether social welfare maximization, the core objective of classical economics, needs to be recast to look at a more equitable distribution of wealth in order to redress historical inequities. It also bypasses any discussion regarding the maleness of corporate behaviour and the caring and collective approaches that women can offer. These are deeply embedded normative notions that have distributional consequences without ever being explicitly acknowledged. While enterprise wealth maximization may be the appropriate interim model for the corporation, it must be

accompanied by a greatly strengthened public law framework in securities law, labour law, human rights protection, consumer protection, and environmental law, and a range of other enforceable standards that temper the wealth-seeking objectives of the corporation.